Chapter 1

INTRODUCTION

Many observers of the American fiscal scene believe that the Federal government should introduce a national sales tax. At the very least, a national sales tax could be used to take pressure off the income tax; that is, it would allow lower income tax rates and these, in turn, would cause less disincentives to work, save, invest productively, and innovate. In addition, a shift in the mix of taxation toward more reliance on taxes on consumption, rather than income, would reduce further the discrimination against saving found in current law. Some advocates of a national sales tax see it as a means of reducing the Federal deficit and its drain on the supply of national saving.

Despite the potential advantages of a national sales tax, the Treasury Department does not recommend that such a tax be adopted at this time. A national sales tax has disadvantages, as well as advantages; though these are not previewed here, they are discussed at length in Chapter 3. The most compelling reason for not proposing a national sales tax results from the context in which the Treasury Department conducted its review of the tax system.

As noted in Chapter 2 of Volume 1, Overview, the Treasury Department proposals are revenue neutral. This implies that any revenue obtained from a national sales tax would be used solely to reduce the income tax. Thus one must ask whether reducing pressure on the income tax would justify introduction of a whole new source of Federal revenue. The Treasury Department estimates that the process of introducing a Federal value-added tax would take roughly 18 months from the date of enactment. Thus, for example, even if a value-added tax were passed by Congress in mid 1986, it could not have an effective date before January 1, 1988. When fully in force, a value-added tax would require 20,000 additional personnel and cost about $700 million to enforce. The Treasury Department has concluded that the advantages of a national sales tax are not sufficient to justify this level of expenditure merely to reduce reliance on the income tax.

This volume considers in greater detail the issues involved in deciding whether or not the United States should adopt a national sales tax. A value-added tax is the type of sales tax that would be most appropriate for use at the Federal level, if a decision were ever made in favor of a national sales tax. This volume therefore concentrates on the description and evaluation of a value-added tax from an economic and administrative perspective. But it also discusses briefly other types of sales taxes.

Chapter 2 provides a basic description of a value-added tax. Value added can be conveniently thought of as the difference between a firm's sales and its purchases from other firms. A value-added tax is a multistage sales tax levied at each point or stage in the production-distribution process. The retail value or price of a product is equal to the total of the values added at each of these stages. Thus, a value-added tax that includes the retail level would have the same aggregate tax base and raise the same amount of revenue as a retail sales tax, assuming the two taxes apply to the same goods and services and are imposed at the same rate of tax.

While there are different forms of value-added tax and alternative methods for calculating tax liability, the only form suitable for the United States would be a consumption-type value-added tax with tax liability determined under the credit method. This means that purchases of capital equipment would, in effect, be deductible in full in the year they are made and that a firm would calculate its tax liability by subtracting value-added tax paid on its purchases from other firms from the tax due on its sales.

Chapter 3 evaluates the economic effects and political concerns that would be associated with a value-added tax. A value-added tax would have several advantages, including neutrality toward saving, capital formation, production techniques, and consumption decisions. But it also would have several disadvantages: regressivity, a one-time increase in prices, Federal intrusion into the sales tax area, significant administration and compliance costs, and the possibility of greater public expenditures.

Chapter 4 evaluates several alternatives to a value-added tax: a retail sales tax, manufacturers and wholesale sales taxes, and a personal exemption value-added tax. Only a value-added tax or a retail sales tax would be basically neutral with respect to consumption and production decisions. That is, a properly designed tax of either type would not seriously distort the consumption behavior of individuals nor the production techniques and methods of business firms. In contrast, any pre-retail tax, such as a manufacturers or wholesale sales tax, would badly distort both consumption and production behavior. The result would be reduced consumer satisfaction and less tax revenue at a given rate. Pre-retail taxes also create substantial administrative problems that would not be present with either a retail sales or value-added tax. Though a retail sales tax and a value-added tax are similar, there may be both administrative and economic reasons for favoring a value-added tax, if a national sales tax is desired.

Chapter 5 discusses a number of specific design issues that would have to be resolved before a value-added tax could be implemented. These include: the distinction and choice between zero rating and exemption, which are two alternatives for providing differential tax treatment to selected commodities, transactions, or firms; the methods for reducing regressivity and the absolute burden of the tax on the poor; the choice between single or multiple rates of tax; and the tax treatment of exports and imports.

A fundamental characteristic of a value-added tax is that it functions most effectively if it is applied uniformly throughout the entire economy. Yet, implementation of this rule may not be possible for some forms of activity. Chapter 6 discusses a number of problem areas in which strict application of a value-added tax may be either difficult or inadvisable. These include some services, small business, farming, governmental entities and nonprofit organizations, housing, used goods, and fringe benefits.

Chapter 7 discusses the likely value-added tax base and the revenue that would be generated by a tax on that base. The projected 1988 level of personal consumption expenditures is about $3.1 trillion; each percentage point of a value-added tax levied on this total would yield about $31 billion. But a realistic base would be well below this figure. Rents, on both tenant and owner-occupied housing, would probably not be taxed. It is also likely that medical care, education, and religious and welfare activities would not be taxed, either for distributional reasons or to encourage certain activities. Banking and insurance may be excluded from the tax base because of the difficulty of properly defining value added in these sectors. These exclusions would result in a value-added tax base of about $2.4 trillion. Exclusions for food and medicine would reduce the base further.

A general sales tax is often criticized as unfair to lower income individuals and families. Two aspects to this equity argument can be distinguished: (1) the absolute burden of the tax on the lowest income groups, and (2) the regressivity of the tax or the relatively higher burden of the tax, as a percentage of income, at the lower income levels than at the middle or upper levels. Chapter 8 discusses four alternatives for reducing the burden of the tax on the poor: excluding certain goods and services from the tax base; providing a reimbursement for value-added tax paid on an average amount of essential consumption; adjusting transfer payments; and using a personal exemption type of value-added tax.

At the Federal level, a value-added tax would be an entirely new form of tax. The Internal Revenue Service would need substantial additional resources to administer a value-added tax properly. Chapter 9 provides the first publicly available appraisal of these additional resource needs.